

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
Johnson & Higgins :

AFFIDAVIT OF MAILING

for Redetermination of a Deficiency or Revision :
of a Determination or Refund of Corporation :
Franchise Tax under Article(s) 9A of the Tax :
Law for the Years Ended 12/31/73, 12/31/74 & :
12/31/75. :

State of New York :

ss.:

County of Albany :

David Parchuck/Janet M. Snay, being duly sworn, deposes and says that he/she is an employee of the State Tax Commission, that he/she is over 18 years of age, and that on the 31st day of October, 1986, he/she served the within notice of Decision by certified mail upon Johnson & Higgins the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Johnson & Higgins
95 Wall Street
New York, NY 10005

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
31st day of October, 1986.

David Parchuck
Authorized to administer oaths
pursuant to Tax Law section 174

Janet M. Snay

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of
Johnson & Higgins :

AFFIDAVIT OF MAILING

for Redetermination of a Deficiency or Revision :
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Franchise Tax under Article(s) 9A of the Tax :
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12/31/75. :

State of New York :

ss.:

County of Albany :

David Parchuck/Janet M. Snay, being duly sworn, deposes and says that he/she is an employee of the State Tax Commission, that he/she is over 18 years of age, and that on the 31st day of October, 1986, he served the within notice of Decision by certified mail upon Kendyl K. Monroe, the representative of the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Kendyl K. Monroe
Sullivan & Cromwell
125 Broad St.
New York, NY 10004

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the representative of the petitioner herein and that the address set forth on said wrapper is the last known address of the representative of the petitioner.

Sworn to before me this
31st day of October, 1986.

David Parchuck
Authorized to administer oaths
pursuant to Tax Law section 174

Janet M. Snay

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

October 31, 1986

Johnson & Higgins
95 Wall Street
New York, NY 10005

Gentlemen:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 1090 of the Tax Law, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Audit Evaluation Bureau
Assessment Review Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2086

Very truly yours,

STATE TAX COMMISSION

cc: Taxing Bureau's Representative

Petitioner's Representative:
Kendyl K. Monroe
Sullivan & Cromwell
125 Broad St.
New York, NY 10004

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
of	:	
JOHNSON & HIGGINS	:	DECISION
for Redetermination of a Deficiency or for	:	
Refund of Franchise Tax on Business Corporations :	:	
under Article 9-A of the Tax Law for the Years	:	
1973, 1974 and 1975.	:	

Petitioner, Johnson & Higgins, 95 Wall Street, New York, New York 10005, filed a petition for redetermination of a deficiency or for refund of franchise tax on business corporations under Article 9-A of the Tax Law for the years 1973, 1974 and 1975 (File No. 24590).

A formal hearing was held before Doris E. Steinhardt, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on September 14, 1984 at 9:00 A.M., with all briefs to be submitted by January 18, 1985. Petitioner appeared by Sullivan & Cromwell, Esqs. (Kendyl K. Monroe, Esq. and Henry Stow Lovejoy, Esq., of counsel). The Audit Division appeared by John P. Dugan, Esq. (William Fox, Esq., of counsel).

Petitioner by its representative, Henry Stow Lovejoy, and the Audit Division by its representative, William Fox, stipulated certain relevant facts which are set forth infra in Findings "1" through "4" and "10".

ISSUES

I. Whether the notices of deficiency issued against petitioner were invalid for failure to state the grounds upon which the asserted deficiencies were premised.

II. Whether employees of Johnson & Higgins who had the titles of vice president, assistant vice president, assistant secretary and assistant treasurer but who did not possess nor exercise any management authority were properly considered by the Audit Division as "elected or appointed officers" for purposes of the third alternative tax base of Tax Law section 210.1(a)(3).

III. Whether the Audit Division's refusal to stipulate certain matters and the delay in scheduling the hearing which ensued therefrom require that the asserted deficiencies be vacated or that the accrual of interest on such deficiencies be suspended for the period May 17, 1982 to September 14, 1984.

IV. Whether the parties' stipulation that, "The franchise tax for the taxable years in question was due and owing pursuant to Section 210.1(a)(1) of the Tax Law", is binding for purposes of this proceeding.

FINDINGS OF FACT

1. Petitioner, Johnson & Higgins, received three notices of deficiency, dated September 15, 1978, with statements of audit adjustment attached, alleging franchise tax deficiencies for the taxable years 1973, 1974 and 1975 in the following amounts:

<u>TAXABLE YEAR</u>	<u>ADDITIONAL AMOUNT</u>
1973	\$ 38,230
1974	181,892
1975	239,139

2. On December 12, 1978, Johnson & Higgins timely filed a petition for redetermination of the deficiencies asserted in the notices of deficiency. On May 7, 1980, that petition was accepted by the Tax Appeals Bureau of the State Tax Commission as a perfected petition.

3. Johnson & Higgins is a corporation incorporated in New Jersey with its principal place of business at 95 Wall Street, New York, New York. Petitioner

is an insurance broker; it engages primarily in the business of designing and marketing insurance and risk management programs and employee benefit plans for its clients.

4. During the years 1973, 1974 and 1975, Johnson & Higgins was subject to the New York State franchise tax. Johnson & Higgins timely filed franchise tax reports on form CT-3 for the taxable years 1973, 1974 and 1975, paying the balance due as indicated thereon. Johnson & Higgins reported entire net income on its reports as follows:

<u>TAXABLE YEAR</u>	<u>ENTIRE NET INCOME</u>
1973	\$2,718,452
1974	830,120
1975	1,384,034

Pursuant to a Federal Revenue Agent's Report, Johnson & Higgins increased its entire net income for 1973 by \$44,800.00 (to \$2,763,252.00) and decreased its entire net income for 1974 by \$19,759.00 (to \$810,361.00). Johnson & Higgins timely filed amended New York State franchise tax reports reflecting these changes.

Johnson & Higgins paid the following amounts of franchise tax for the taxable years in question:

<u>TAXABLE YEAR</u>	<u>FRANCHISE TAX</u>
1973	\$211,865
1974	15,657
1975	117,293

5. Petitioner's executive officers consist of the chairman of the board, the president, the executive vice president, those vice presidents who are also directors, the secretary and the treasurer. In order to be eligible as a director, a person must be a stockholder owning not less than 500 shares; the stock of Johnson & Higgins is owned entirely by its directors.

6. The directors, referred to in the corporation as the executive officer group, possess the authority and responsibility for managing the affairs of the corporation. The directors determine the manner in which the firm's business is conducted, the type of client relationships the firm undertakes and the salary range for all employees. The approval of an executive officer is required before any person can be added to the staff and before any employee can be dismissed. During the period under consideration, the number of executive officers was approximately seventeen. The salaries of the executive officers are calculated in accordance with a formula in the corporation's charter; during the years 1973 through 1975, the average annual compensation of the executive officers was approximately \$200,000.00.

7. Sometime during the 1930's, the directors began to confer upon certain employees the titles of vice president and assistant vice president to accomplish a number of purposes: to enhance the employees' stature with the firm's clients; to afford them a measure of recognition within the firm; to enable them to be sub-licensees of the corporate licensee (Johnson & Higgins) in compliance with the Insurance Law; and to conform with the practices of the insurance brokerage industry. Article V of petitioner's Amended Certificate of Incorporation (as amended to May 6, 1970) provides, in pertinent part:

"The Board of Directors may appoint additional Vice Presidents and Assistant Vice Presidents with such powers and duties and compensation as shall be conferred upon them by such Board of Directors, but any Vice President or Assistant Vice President so appointed shall not be deemed to be, or be, an Executive Officer of the Corporation."

The management of the firm continues to reside in the board of directors; the non-executive officers are not charged with nor do they perform any of the functions of the executive officers.

8. Generally, an individual must function satisfactorily as an assistant vice president for three to five years before becoming a vice president. During each of the years 1973 through 1975, there were approximately 185 Johnson & Higgins employees holding the title of vice president and assistant vice president; these employees represented approximately 40 percent of petitioner's work force. The average salary of a vice president was \$33,000.00 to \$35,000.00 and of an assistant vice president, approximately \$10,000.00 less. The non-executive officers have their titles imprinted on their business cards, but the firm does not list them as officers on its letterhead nor in the building directory.

9. The directors also named certain employees as assistant secretaries and assistant treasurers; during the years at issue, approximately two employees held the title of assistant secretary and three, that of assistant treasurer.

10. For the taxable years in question, Johnson & Higgins paid the following total amounts of salaries to all employees: 1973 - \$15,521,670.00; 1974 - \$16,621,036.00; 1975 - \$18,314,253.00. The compensation paid which the Audit Division seeks to include in the tax base is shown below.

	<u>1973</u>	<u>1974</u>	<u>1975</u>
Principal officers and directors	\$1,511,689	\$1,539,230	\$1,674,863
Other officers and directors	1,384,125	1,393,151	1,593,972
Vice presidents	3,199,035	3,488,591	4,030,837
Assistant vice presidents	1,652,677	2,041,672	2,353,588
Assistant treasurers	34,923	90,177	79,750
Assistant secretaries	52,938	50,192	91,250
Directors' fees	11,250	12,000	12,750
	<u>\$7,846,637</u>	<u>\$8,615,013</u>	<u>\$9,837,010</u>

11. The examination which resulted in the deficiencies at issue was commenced in April, 1977. The names and compensation of all officers, executive and non-executive, were furnished by petitioner to the examiner. On April 20, 1978, the examiner mailed to petitioner the amounts of his proposed audit

adjustments and photocopies of supporting schedules. He did not provide petitioner with a written explanation of the grounds for the deficiencies. The statements of audit adjustment issued to petitioner simultaneously with the notices of deficiency offered the following explanation: "The above deficiency is based on the findings of a recent field audit."

12. The hearing in this matter was initially scheduled for May 22, 1981 but was adjourned at petitioner's request. The hearing was rescheduled for May 17, 1982, and notice thereof mailed to petitioner and its representative on April 12, 1982. On April 16, 1982, petitioner filed a motion to compel stipulation, as provided by the Tax Commission's Rules of Practice and Procedure (20 NYCRR 601.7[f]). The Commission then adjourned the hearing set for May 17, 1982 pending action on petitioner's motion. On May 25, 1984, by a Short Form Order, the Commission denied the motion to compel on the ground that the Audit Division had "furnished substantial reasons for its refusal to stipulate...". At the hearing held on September 14, 1984, the Audit Division introduced no evidence to disprove the matters concerning which petitioner had requested stipulation.

13. Paragraph 7 of the executed stipulation provides as follows:

"7. The Franchise Tax for the taxable years in question was due and owing pursuant to Section 210.1(a)(1) of the Tax Law."

The Audit Division requested that the above-quoted paragraph be inserted in the stipulation.

CONCLUSIONS OF LAW

A. That the statements of audit adjustment and notices of deficiency issued to petitioner clearly indicate that the asserted deficiencies were founded on a field examination, the results of which had been earlier provided

to petitioner. It thus cannot be said that the Audit Division failed to apprise petitioner of the basis for the deficiencies.

B. That Tax Law section 210.1(a), as in force during the years at issue, required the corporate taxpayer to calculate the franchise tax upon whichever of the following four alternative bases yielded the greatest liability: (1) nine percent of entire net income (or the portion thereof allocated to New York); (2) one and six-tenths mill for each dollar of its total business and investment capital (or the portion thereof allocated to New York); (3) nine percent on thirty percent of entire net income plus "salaries and other compensation paid to the taxpayer's elected or appointed officers and to every stockholder owning in excess of five per centum of its issued capital stock minus fifteen thousand dollars..."; or (4) \$125.00. The third alternative base, entire net income plus compensation, was enacted in 1929 to address the problem of unreasonable compensation; it constitutes an attempt to preclude shareholding officers and substantial shareholders of corporations from withdrawing disproportionate amounts of money from the corporations as deductible salaries, rather than as nondeductible dividends. (Memorandum from Deputy Commissioner Cole to Commissioner Lynch [March 22, 1929] in Governor's Bill Jacket, N.Y. Session Laws, Chapter 385 [1929].)

For purposes of the third alternative base, the regulations defined "elected or appointed officer", in pertinent part, as follows:

"An 'elected or appointed officer' includes the chairman, president, vice-president, secretary, assistant secretary, treasurer, assistant treasurer, comptroller, and also any other officer, irrespective of his title, who is charged with and performs any of the regular functions of any such officer. A director is not an elected or appointed officer unless he performs duties ordinarily performed by an officer." Ruling of State Tax Commission, March 14, 1962, section 3.20(c). (The current regulation contains substantially similar language. 20 NYCRR 3-3.2[d].)

C. That section 119, subsection 2 of the Insurance Law provides in part:

"The superintendent may issue an insurance broker's license to any individual, firm, association or corporation, hereinafter designated as 'licensee,' who or which is deemed by him trustworthy and competent to act as a broker in such manner as to safeguard the interests of the insured, and who or which is otherwise qualified as herein required, and who or which has complied with the prerequisites herein prescribed... Such license shall confer upon the licensee authority to act in this state as insurance broker, and upon every natural person named as sub-licensee in such license authority to act in this state as insurance broker in the name of and on behalf of such licensee, with respect to any and every kind of insurance, except life insurance and annuities. A license issued to a corporation may name as sub-licensees only the officers and directors of such corporation, and a license issued to a firm or association may name as sub-licensees only the individual members of such firm or association."

Petitioner is required by the above-quoted provision to designate as officers those persons it names as sub-licensees of its insurance broker's license; without being licensed, an employee of petitioner cannot work as an insurance broker. Further, by the terms of petitioner's Certificate of Incorporation, these designated officers are not executive officers and possess only such authority as the directors confer upon them, i.e., to engage in business as insurance brokers. Given these unique circumstances, petitioner's non-executive officers are not "elected or appointed officers" within the meaning of Tax Law section 210.1(a)(3). A contrary conclusion would require the inclusion in the tax base of the compensation of nearly 190 "officers", employees who had no say in petitioner's management and whose average remuneration represented approximately 15 percent of an executive officer's compensation, and would not effectuate the legislative purpose of the third alternative base.


D. That the remaining issues are rendered moot by the foregoing conclusion.

E. That the petition of Johnson & Higgins is granted, and the notices of deficiency issued on September 15, 1978 are cancelled.

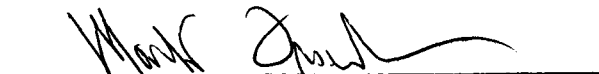
DATED: Albany, New York

STATE TAX COMMISSION

OCT 31 1986


PRESIDENT


COMMISSIONER


COMMISSIONER